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**"And for so long thereafter - Paying
Quantities, Shutting-in, and Other Legal
Problems of the Secondary Term"**

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AND FOR SO LONG THEREAFTER . . . "PAYING QUANTITIES", "SHUTTING-IN" AND OTHER LEGAL PROBLEMS OF THE SECONDARY TERM

**A PRESENTATION BEFORE THE 1991 ARKANSAS NATURAL RESOURCES
LAW INSTITUTE**

By: Thomas A. Daily

An oil and gas lease is a contract between the owner of underground oil and gas (the "Lessor") and a prospector (the "Lessee"). The Lessee is granted exclusive exploration and development rights. Consideration to the Lessor includes some fraction of anticipated production (the "royalty"). The grant is first for a term of years. That term, called the "primary term", can be absolutely vested, as in the case of the "paid-up lease"; or it can be just one year followed by successive annual renewal options which the Lessee may exercise by payment of a specified sum ("delay rental"). In either case, the primary term is relatively short, considering the time ordinarily required to fully develop and produce. For that reason, virtually every oil and gas lease also contains language permitting it to be perpetuated beyond its primary term, if, at the end of the primary term, one of several conditions is present.

An oil and gas lease will not expire at the end of its primary term if the Lessee commences operations prior to expiration and those operations are continuously prosecuted. Even if those operations result in a dry hole, the Lessee can continue the lease by commencing operations for additional drilling within sixty days¹ from the cessation of the first operations. The typical lease form also contains a "force majeure clause" which purports to preclude termination should drilling operations be prevented during the last year of the primary term by force majeure. These extenders of the primary term all have one thing in common--they are temporary.

Drilling operations someday will end. Force majeure likewise can be expected to end

¹or some other stated time.

sooner or later.² Ultimately, an oil and gas lease will continue on into the secondary term only if production occurs.

This lease shall remain in force for a primary term of _____ years and as long thereafter as oil, gas or other hydrocarbons is produced from said lease premises or from lands pooled therewith.³

It is agreed that this lease shall remain in force for a term of _____ years from date (herein called primary term) and as long thereafter as oil or gas, or either of them is produced from said land by the lessee.⁴

In theory, the secondary term of the oil and gas lease can last forever, provided the Lessee is fortunate enough to find perpetual production. Unfortunately, from the standpoint of the Lessee, there are many ways for the secondary term to end prior to eternity. We shall consider a few of those.

PAYING QUANTITIES

The Habendum Clauses of both the A.A.P.L. 680 and the Producer's 88 Lease Forms extend the leasehold for as long as oil or gas is "produced". Read literally, these clauses would extend the lease if there was any production, regardless how pitiful and, regardless how dismal the future outlook. However, the courts of oil and gas producing states are virtually unanimous in finding that "production" means more than just any production. It means production in "paying quantities".⁵

Courts have not been nearly so unanimous when it comes to defining "paying

²If a force majeure becomes permanent, it is doubtful that anyone else would want the lease anyway. The issue then might well be whether or not a compensable inverse condemnation has occurred.

³A.A.P.L. Form 680 Oil and Gas Lease. "Habendum Clause"

⁴Producer's 88 Oil and Gas Lease Form. "Habendum Clause"

⁵*Turner v. Reynolds Metal Co.*, 290 Ark. 481, 721 S.W.2d 626 (1986); *Barnard v. Gibson*, 100 Cal.App.2d 527, 224 P.2d 90 (1950); *Adolf v. Stearns*, 235 Kan. 622, 684 P.2d 372 (1984); *Cumberland Contracting Company v. Coffey*, 405 S.W.2d 553 (Ky. 1966); *Michigan Wisconsin Pipeline Co. v. Michigan National Bank*, 118 Mich.App. 74, 324 N.W.2d 541 (1982); *Henry v. Clay*, 274 P.2d 545 (Okla. 1954); *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509 (1942); In Louisiana, the same result is required by statute. See, LSA-R.S. 31:124.

quantities". An analysis of the many relevant decisions yields two possible approaches, the "arithmetic" test and the "prudent operator" test. Under the arithmetic test the court simply compares the revenue from the well or wells on the lease premises with certain expenses of the well(s) over some relevant period and, if income exceeds expenses, the production is in "paying quantities". If not, the lease expires.⁶

Courts which use the prudent operator test first perform the same arithmetical analysis. If that exercise yields a profit, then paying quantities are found. If not, the prudent operator test still yields "paying quantities" if, notwithstanding the unprofitable arithmetic, a reasonably prudent operator would continue to produce the well anyway.⁷

PAYING QUANTITIES - THE ARITHMETIC TEST

At first blush the arithmetic test appears easy for a court to apply. Either the well makes money or it doesn't, right? Wrong. There is plenty left for lawyers to argue about. For example, which expenses should be off-set against income from a well? The authorities agree that drilling, completing, equipping, testing and reworking costs are not to be included.⁸ The Lessee has already spent these and should be entitled to recoup as much of them as possible, if they can be recouped without additional loss.

On the other hand, labor costs are clearly off-settable against income.⁹ Taxes on production and production equipment are also included.¹⁰ Depreciation on original equipment should not be included since it is part of the cost of original drilling,¹¹ but depreciation on

⁶Kuntz, *The Law of Oil and Gas* § 26.7 (g) [1979 Replacement].

⁷Kuntz, *The Law of Oil and Gas* § 26.7 (f) [1979 Replacement].

⁸See *Summers Oil and Gas* § 306 and those cases cited in footnote 25 thereto.

⁹*Turner v. Reynolds Metal Co.*, 290 Ark. 481, 721 S.W.2d 626 (1986); *Edwards v. Hardwick*, 350 P.2d 495 (Okla. 1960); *Kerr v. Hillenberg*, 373 P.2d 66 (Okla. 1962); *Fick v. Wilson*, 349 S.W.2d 622 (Tex.App. 1961); *Persky v. First State Bank*, 117 S.W.2d 861 (1938).

¹⁰*Henry v. Clay*, 274 P.2d 545 (Okla. 1954); *Fick v. Wilson*, 349 S.W.2d 622 (Tex.App. 1961).

¹¹*Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959).

production equipment should be included¹². That equipment presumably could be salvaged and used for some other purpose. It is unclear whether a well should be charged with some share of the operator's overhead expenses. Cases from Kansas and Texas indicate that some overhead expenses can be included.¹³ Oklahoma clearly excludes them.¹⁴ Royalties paid to the Lessor should be included.¹⁵ Overriding royalties, on the other hand, have usually been excluded.¹⁶ Excluding overriding royalties makes sense, since to do otherwise would require an examination of the relationship between each working interest owner and override owner, to determine whether the override was truly an expense or merely a division of income.

To what period of time do we apply our arithmetic?¹⁷ The selection of the appropriate time frame within which to measure paying quantities is critical. While there are some wells that have never made a profit and, for that matter, never will, many marginal wells were profitable at first but have become less profitable as their reserves depleted. Other factors, like state mandated production allowables, price fluctuations, purchasers' takes from the well and supply and demand in general make nonsense of any arbitrary testing period. The fact that a well is not producing a profit over a given period is merely one factor. To become obsessed with that factor is to ignore the realities of the industry. The arbitrary selection of a time period can make a profitable well unprofitable or vice versa. Either way, no study of the past considers prospects for the future. It's unfair to deprive the Lessee of his investment if there is reasonable basis to expect better times ahead for the well, as may well be the case

¹²*Skelly Oil Co. v. Archer*, 163 Tex. 336, 356 S.W.2d 774 (1961).

¹³*Reese Enterprises, Inc. v. Lawson*, 220 Kan. 300, 583 P.2d 885 (1976); *Skelly Oil Co. v. Archer*, 163 Tex. 336, 356 S.W.2d 774 (1961).

¹⁴*Mason v. Ladd Petroleum Corp.*, 630 P.2d 1283 (Okla. 1981).

¹⁵*Henry v. Clay*, 274 P.2d 545 (Okla. 1954); *Skelly Oil Co. v. Archer*, 163 Tex. 336, 356 S.W.2d 774 (1961).

¹⁶*Transport Oil Co. v. Exeter Oil Co.*, 84 Cal. App. 2d 616, 191 P.2d 129 (1948); *Hininger v. Kaiser*, 738 P.2d 137 (Okla. 1987); *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959).

¹⁷For a comprehensive list of the multitude of cases dealing with the appropriate time period, see the annotation at 43 A.L.R.3d 8 § 7, beginning at 43 A.L.R. 60.

in times of low prices, low demand, low production allowables or some combination of these, the reversal of which might reasonably be forecast. Indeed, under such circumstances, the Lessee should be praised. He takes a licking and keeps on ticking, so to speak, so that in the end both he and the Lessor might profit when adverse marketing conditions improve.

In recent times, one state, Kansas, has embraced the arithmetic test and specifically rejected subjective considerations. In *Reese Enterprises, Inc. v. Lawson*¹⁸, the Kansas Supreme Court stated:

In our opinion, the better approach is to follow the innumerable cases which apply an objective test, where the determination of 'paying quantities' turns upon a mathematical computation. (See cases accumulated in Annot. 43 A.L.R.3d 8 [1972]; 21 J.B.A.K. 320 [1953]; and 2 Kuntz, A Treatise on the Law of Oil and Gas § 26.7 [1964].¹⁹

With all due respect to the Kansas Court, the authorities upon which it relies are not all that innumerable.²⁰

PAYING QUANTITIES - THE PRUDENT OPERATOR TEST

The prudent operator test recognizes that unless the Lessee is trying to hold on to the lease for purely speculative purposes, his interest, and those of the Lessor, are common. Unlike the Lessor, and unlike most judges and virtually all juries, the Lessee is in a good position to know whether or not a well is worth keeping. There are many cases which apply this test.²¹ Probably its most honored statement is in the landmark Texas case of *Clifton v. Koontz*²²:

¹⁸220 Kan. 300, 553 P.2d 885 (1976).

¹⁹553 P.2d at 897.

²⁰Indeed the thrust of Professor Kuntz' treatise cited in *Reese v. Lawson* is contrary to that decision: "There are innumerable cases hereinafter cited which purport to apply an objective test, with the determination turning upon a mathematical computation. In application, however, the two tests tend to blend in such a manner that the difference is largely one of emphasis." Kuntz, *The Law of Oil and Gas* § 26.7 [1979 Replacement].

²¹See 43 A.L.R.3d 8 § 10, beginning on page 73 and those cases cited therein.

²²160 Tex. 82, 325 S.W.2d 684 (1959).

In the case of a marginal well, such as we have here, the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated.

In determining paying quantities, in accordance with the above standard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of the factors are: The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.²³

The majority of oil and gas jurisdictions which have specifically chosen between the tests have chosen the prudent operator test, many citing *Clifton v. Koontz* with approval.²⁴

PAYING QUANTITIES - THE ARKANSAS CASES

Over the years, at least three Arkansas cases have dealt with the definition of "paying quantities". In *Reynolds v. McNeill*²⁵, the issue was whether a lease had terminated for failure of an oil well to produce in paying quantities. The Arkansas Supreme Court, in an opinion written by Justice George Rose Smith, upheld the lease. While *Reynolds v. McNeill*, like many other early cases, fails to articulate the prudent operator test with the precision found in *Clifton v. Koontz*²⁶, it is clear that the Court did consider subjective factors:

Peterson had drilled the well, and his statement as to its initial production is entitled to much more weight than that of other witnesses who had little or no personal knowledge of the facts.

. . .

The Chancellor was right in refusing to declare a forfeiture. The

²³325 S.W.2d 684 at 691.

²⁴*Webb v. Hardage Corporation*, 471 So.2d 889 (La.App. 2 Cir. 1985) (applying LSA-R.S. 31:124); *Michigan Wisconsin Pipeline Co. v. Michigan National Bank*, 118 Mich. App. 74, 324 N.W.2d 541 (1982); *Barby v. Singer*, 648 P.2d 14 (Okla. 1982); *Henry v. Clay*, 274 P.2d 545 (Okla. 1954). See, also, *Cumberland Contracting Company v. Coffee*, 405 S.W.2d 553 (Ky. 1966).

²⁵218 Ark. 453, 236 S.W.2d 723 (1951).

²⁶160 Tex. 82, 325 S.W.2d 684 (1959).

lessee and his assignees had spent large sums in successfully attaining production within the primary term of six months. When that event occurred, a valuable estate vested in the lessee, to continue as long as oil or gas was produced in paying quantities.

The appellants contend, however, that the estate terminated at the end of the primary term because oil was no longer being produced in commercial amounts. According to the weight of authority, and we think the better view, when the lessee's estate has vested it does not automatically terminate upon a temporary cessation of production. In ventures of this kind, the lessee makes a very substantial investment and bears the entire loss if the well is unproductive. It would be harsh and inequitable to say that upon a temporary stoppage of production, the lessor can declare a forfeiture and take over the property himself. Hence, most authorities allow the lessee a reasonable time within which to reinstate paying production.

. . .

We are not willing to say that the Chancellor was wrong in giving the appellee sixty days of grace in which to resume paying production. The lessee has never relaxed his efforts to make the well profitable to the lessors. When the output of saltwater became too great for the pump, Peterson removed the pipe and installed a larger one in the hope of increasing the withdrawal of oil. After Peterson gave up the well, McNeill took it over and was about to begin cleaning out the sand when the lessors abruptly decided that a forfeiture had occurred months before. Dan Reynolds testified with commendable candor that he thought the well had possibilities and that if the lease should be cancelled, he intended to try to rework the well by removing the sand in the casing. McNeill and those working with him, have expended over forty thousand dollars in attaining production and in attempting to continue that production. They have not abandoned their efforts for any appreciable time. The Appellants did not make their dissatisfaction known until three days before suit was filed. They are not in the position to complain of the Chancellor's ruling.

Then, thirty five years after *Reynolds v. McNeill*, came the bombshell case of *Turner v. Reynolds Metal Co.*²⁷. In 1951, Homer and Jean Turner executed an oil and gas lease which was assigned to Reynolds Metal Company. During the primary term of the lease, Reynolds drilled and completed a gas well known as the "J. T. Nichols #1" in a unit which included the lands covered by the lease. Exhibits filed with the trial court show production from the well from June of 1964 forward. In the last seven months of 1964, the well produced 15,402 MCF

²⁷290 Ark. 481, 721 S.W.2d 626 (1986).

of gas. In subsequent years, the production was: 1965, 13,168 MCF; 1966, 9,443 MCF; 1967, 7,206 MCF; 1968, 6,344 MCF; (1969 production is not shown due to an apparent colation error in the exhibit); 1970, 6,814 MCF; 1971, 8,665 MCF; 1972, 6,989 MCF; 1973, 7,344 MCF; 1974, 6,301 MCF; 1975, 5,312 MCF; 1976, 6,576 MCF; 1977, 6,031 MCF; 1978, 6,503 MCF; 1979, 6,119 MCF; 1980, 4,594 MCF; 1981, 3,198 MCF. These numbers indicate an extremely marginal well. Production allowables were apparently not the problem, because production figures for other wells within the same field are much much higher. There is no evidence in the record whether the well was capable of producing at greater volumes, but presumably it was not. The well's woes were complicated by a long term gas contract entered into between Reynolds and Arkansas Louisiana Gas Company which set a price of 27¢ per MCF for the gas. That contract was set to expire July 1, 1984. In 1975, Reynolds apparently realized that the revenues from the Nichols Well put it in the marginal category. On July 8 of that year, it obtained an agreement from the Turners and other Lessors that, in consideration of a cash payment, the lease would continue until July 8, 1980 notwithstanding production, and thereafter as long as there was production. Production at the above levels continued for the five years covered by the agreement and thereafter. In February of 1981, after the five year extension term had expired, Reynolds wrote Arkla asking for a higher price on gas produced from any new wells on the lease and, in October of that year, Arkla agreed that gas from any new wells would be purchased at the NGPA new gas price which was about \$1.50 per MCF. Reynolds promptly applied for a drilling permit for a new well. Before that well could be commenced, Mrs. Turner²⁸, sued for cancellation of the lease, alleging that the first Nichols well had failed to produce in paying quantities. Although Mrs. Turner's complaint uses the term "cancellation", it is apparent that she really sought a declaratory judgment that the lease had expired of its own terms, for failure to produce in paying quantities. Undaunted, on February 9, 1982, Reynolds commenced the drilling of the Nichols #2 Well and it was completed on July 9, 1982. According to the completion report filed with Arkansas Oil and

²⁸then a widow

Gas Commission it is capable of producing over a million cubic feet of gas (1,000 MCF) per day.

The case was submitted to the court on stipulated facts including the pitiful revenue produced by the first well and the fact that Reynolds had paid a pumper \$13,200 per year to look after that well and nine others. Because the case was submitted on stipulation, there was no testimony either way as to whether or not a prudent operator would have continued to produce the well, notwithstanding the fact that it was losing money.²⁹

The trial court held that the #1 Nichols Well had produced in paying quantities and refused to terminate the lease. Mrs. Turner appealed and the Supreme Court reversed.³⁰

In its opinion, written by Justice Darrell Hickman, the Arkansas Supreme Court compared the revenue from the #1 Nichols Well between 1975 and the middle of 1982 to 1/10 of the pumper's annual salary. On that basis the well had lost money in every year of the secondary term and had failed to produce in paying quantities. Little mention was made of Reynolds efforts to secure a higher price or of the new well. It is obvious that the Court thought Reynolds had taken those actions only when prodded by the lawsuit. The Court's opinion contains no discussion of prudent operations nor does it mention *Reynolds v. McNeill*³¹ Even though that case is cited in both parties' briefs.³²

Turner v. Reynolds has been subjected to considerable criticism.³³ If the case means simple arithmetic determines "paying quantities" in Arkansas, it deserves that criticism and

²⁹One can imagine that a prudent operator, called as an expert witness, would have been able to foresee better days ahead with the old gas purchase contract expiring and the successful re-negotiation of the price for gas from new wells. Indeed, by November, 1985, when the stipulation was submitted to the trial Court, the old gas purchase contract had expired and the #1 well had been eligible for the higher price for over a year. Moreover, the #2 well was by any standard, a good well.

³⁰*Turner v. Reynolds Metal Co.*, 290 Ark. 481, 721 S.W.2d 626 (1986).

³¹218 Ark. 453, 236 S.W.2d 723 (1951).

³²Neither party cited cases from other jurisdictions having to do with the appropriate test for measuring "paying quantities".

³³*See, e.g., Norvell*, Discussion Notes, 92 O. & G.R. 247.

more. On the other hand, there is plenty of justification for its result. After its first two years, the #1 Nichols Well never produced more than 10,000 MCF per year. Even at \$1.50 per MCF that's less than \$15,000 per year; not much for a gas well, in this day and age. The pumper's salary was the only expense proven at the trial, but the well surely had other expenses. Remember also that the \$1.50 price was not available until the well had produced for twenty years, meanwhile yielding next to nothing. The Court could easily have found that no prudent operator would have produced the well for such a long time, unless motivated by pure speculation. In other words, the Court could easily have applied the analysis of *Clifton v. Koontz*³⁴ and reached exactly the same result. Then, the only legitimate criticism would have to do with the Court's repeated use of the term "cancellation" when it probably meant that the lease had expired of its own terms.

The following year the Arkansas Supreme Court decided the case of *Perry v. Nicor Exploration*³⁵. The *Perry* case presents somewhat different facts. It involved a good well. However, some of the leases were committed to long-term gas purchase contracts paying 17¢ per MCF. Other leases were contracted for prices up to \$1.74 per MCF. The Court held that the well, as a whole, had produced in paying quantities, and found it immaterial that certain of the leases had not produced a profit, in and of themselves.³⁶ The Court never needed to discuss the prudent operator standard since the well, as a whole, was profitable arithmetically.

An analysis of these Arkansas cases yields few, if any, answers. The Court used subjective considerations in *Reynolds v. McNeill*³⁷, it used simple arithmetic in *Turner v. Reynolds Metal Co.*³⁸, and, in *Perry v. Nicor Exploration*³⁹, it didn't need to dwell on either

³⁴160 Tex. 82, 325 S.W.2d 684 (1959).

³⁵293 Ark. 417, 738 S.W.2d 414 (1987).

³⁶In Arkansas, the base 1/8th royalty is paid out of 1/8th of all proceeds of production, pooled for that purpose (A.C.A. § 15-72-305 (a)). Thus, Lessors of the 17¢ leases were receiving more than 1/8th of 17¢ and, by the same token, Lessors of the \$1.74 leases were receiving much less than 1/8th of \$1.74.

³⁷218 Ark. 453, 456 S.W.2d 723 (1951.)

³⁸290 Ark. 481, 721 S.W.2d 626 (1986).

approach. Jurisprudence might have been better served by the utilization of the prudent operator standard in *Turner v. Reynolds Metal Co.* but it is doubtful that the result would have been any different.⁴⁰ Also, the Court constantly talked of "cancellation", but the apparent holding was that the lease had expired of its own terms.

PAYING QUANTITIES - "EXPIRATION" OR "CANCELLATION"

If the primary term has expired and the well stops producing in paying quantities does the lease automatically expire of its own terms, or must it be cancelled? If the secondary term lasts only "so long thereafter" as there are paying quantities, then it would seem the lease should expire. That has been the result, according to Professor Kuntz, in Kansas, New York, Texas, New Mexico, Illinois, Tennessee, California, Nebraska, Louisiana, Michigan, Montana and Ohio.⁴¹

On the other hand, since most habendum clauses literally only require "production", paying quantities being implicit therein, a court could reasonably hold that some production, though not in paying quantities, might hold the lease after paying quantities cease to be produced, until the lease is cancelled in an action brought by the Lessor. Several states have so held, or implied. According to Professor Kuntz, they are Colorado, Kentucky, Mississippi, Oklahoma, Pennsylvania, West Virginia, Wyoming, and possibly Indiana and North Dakota.⁴² Oklahoma is perhaps the staunchest "cancellation" jurisdiction. The Oklahoma case most often cited is *Stewart v. Amerada Hess Corp.*⁴³:

The 'thereafter' clause is hence not ever to be regarded as akin

³⁹293 Ark. 417, 738 S.W.2d 414 (1987).

⁴⁰For a case remarkably similar to *Turner v. Reynolds Metal Co.*, see *Lough v. Coal Oil, Inc.*, 266 Cal. Rptr. 611 (1990). In that case the California Court held that a lease had expired for failure to produce an arithmetical profit and failed to give any mention to subjective considerations. However, it is doubtful that a prudent operator would think much of the well in that case either.

⁴¹Kuntz, the Law of Oil and Gas, § 26-8 [Replacement 1989].

⁴²*Ibid*

⁴³604 P.2d 854 (Okla. 1979).

in effect to the common law conditional limitation or determinable fee estate. The occurrence of the limiting event or condition does not automatically effect an end to the right. Rather, the clause is to be regarded as fixing the life of a lease instead of providing means of terminating it in advance of the time at which it would otherwise expire. In short, the lease continues in existence so long as interruption of production in paying quantities does not extend for a period longer than reasonable or justifiable in light of all the circumstances involved. But under *no* circumstances will cessation of production in paying quantities *ipso facto* deprive the lessee of his extended term estate.⁴⁴

Professor Kuntz also lists Arkansas as a "cancellation" state, citing *Reynolds v. McNeill*⁴⁵. As noted above, the Arkansas Court also speaks of cancellation in *Turner v. Reynolds Metal Co.*⁴⁶, but the Court treats the lease as having expired. Reynolds argued passionately that equity abhors a forfeiture and cited the potential loss of its newly drilled well as the dire consequence of such a forfeiture. The Court turned a deaf ear saying:

Reynolds later negotiated a higher purchase price for the gas in February 1985⁴⁷ and in 1982 drilled a second well which will produce when connected to a pipeline. However, these efforts are irrelevant because they were made after Turner was entitled to cancel the lease.⁴⁸

These considerations would be very relevant if cancellation was at issue, since cancellation is equitable in nature and equity does indeed abhor a forfeiture. If, however, the Court meant to say "the lease had expired" then such considerations would truly be irrelevant.

THE CONSEQUENCE OF LACK OF MARKET

Suppose the Lessee drills a well during the primary term but is not actually marketing production from the well when the primary term expires. Suppose, also, that the particular

⁴⁴604 P.2d at 858.

⁴⁵218 Ark. 453, 236 S.W.2d 723 (1951).

⁴⁶290 Ark. 481, 721 S.W.2d 626 (1986).

⁴⁷The Court probably meant 1981.

⁴⁸290 Ark. 481 at 484, 721 S.W.2d 626 at 628.

lease has no shut-in clause.⁴⁹ In some states, "production" requires marketing and, therefore, failure to market at the expiration of the primary term would cause the lease to expire. Those states include Texas⁵⁰, Louisiana⁵¹, New Mexico⁵² and Kansas⁵³. According to Professor Kuntz, Illinois, Michigan, Ohio and Tennessee follow that view as well.⁵⁴ In these states the lease is saved only if it contains a shut-in clause which permits the Lessee to shut-in the well and pay a minimum royalty.

The courts of several other states have held that a discovery of paying quantities is equivalent to "production" in paying quantities. These states include West Virginia⁵⁵, Montana⁵⁶, Wyoming⁵⁷ and, most notably Oklahoma⁵⁸. In these states, a shut-in clause is not a necessity as long as the Lessee acts as a prudent operator to find a market for the production.

The Arkansas Court has apparently never decided this issue.

In all states, the Lessee can hold the lease with a shut-in well if the lease contains a shut-in gas clause and if the Lessee complies with the terms of that clause. It must be

⁴⁹Most modern oil and gas leases do contain shut-in clauses but this is not just an academic exercise. The answer impacts significantly upon the result when the Lessee fails to timely pay shut-in royalty under its shut-in clause.

⁵⁰*Union Oil of Cal. v. Ogden*, 278 S.W.2d 246 (Tex. Civ. App. 1955); *Rogers v. Osborn*, 152 Tex. 540, 261 S.W.2d 311 (1953).

⁵¹*Smith v. Sun Oil Co., Inc.*, 172 La. 655, 135 So. 15 (1931); *Landry v. Flaitz*, 245 La. 223, 157 S.2d 892 (1963).

⁵²*Town of Tome Land Grant, Inc. v. Ringle Development Co.*, 56 N.M. 101, 240 P.2d 850 (1952); *Greer v. Salmon*, 82 N.M. 245, 479 P.2d 294 (1970).

⁵³*Reese Enterprises, Inc. v. Lawson*, 220 Kan. 300, 553 P.2d 885 (1986).

⁵⁴Kuntz, *the Law of Oil and Gas* § 26.6 [1979 replacement].

⁵⁵*Eastern Oil Co. v. Coulehan*, 65 W.Va. 531, 64 S.E. 836 (1909); *South Penn Oil Co. v. Snodgrass*, 71 W.Va. 438, 76 S.E. 961 (1913).

⁵⁶*Fey v. A.A. Oil Corp.*, 129 Mont. 300, 285 P.2d 578 (1955).

⁵⁷*Pryor Mt. Oil and Gas Co. v. Cross*, 31 Wyo. 9, 222 P. 570 (1924).

⁵⁸*McVicker v. Horn, Robinson and Nathan*, 322 P.2d 410, 71 A.L.R.2d 1211 (Okla. 1958)

emphasized, however, that no shut-in gas well will hold a lease in its secondary term unless that well is capable of producing in paying quantities.⁵⁹ A Lessee cannot hold a lease by completing a non-commercial well, shutting it in and paying shut-in royalty.⁶⁰

FAILURE TO TIMELY PAY SHUT-IN ROYALTY

What if a well is drilled during the primary term which is capable of producing in paying quantities, but is shut-in for lack of a market. Then what if the Lessee either fails to pay shut-in royalty or pays it incorrectly? Does the lease terminate? In states like Oklahoma, where discovery is equivalent to production, the lease will not terminate⁶¹ although the Lessor is probably entitled to recover the shut-in royalties in an action for debt.⁶² In those jurisdictions like Texas, where marketing is required, failure to timely pay shut-in royalty has been fatal.⁶³

It would be easy to generalize that the consequence of failure to properly pay shut in royalty is always determined by whether a state requires marketing or merely discovery for purposes of the Habendum clause. Remember, though, that each oil and gas lease is a separate contract. These contracts are not all identical. This is particularly true of shut-in clauses. Compare this clause:

During any period (whether before or after expiration of the primary term hereof) when gas is not being so sold or used and the well or wells are shut-in and there is no current production of oil or operations on said leased premises sufficient to keep this lease in force, Lessee shall pay or tender a royalty of One Dollar (\$1.00) per year net royalty acre retained herein, such payment or tender to be made, on or before the anniversary date of this lease

⁵⁹Kuntz, *The Law of Oil and Gas* § 46.4 (e) [1990 Replacement].

⁶⁰*Ibid*

⁶¹*Flag Oil Corp. v. King Resources Co.* 494 P.2d 322 (Okla).

⁶²Kuntz, *The Law of Oil and Gas* § 46.5 [Replacement 1990].

⁶³*Rogers v. Osborne*, 152 Tex. 540, 261 S.W.2d 311 (1953); *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 171 S.W.2d 339 (1943); *Amber Oil and Gas Company v. Bratton*, 711 S.W.2d 741 (Tex.App. 1986); *Steeple Oil and Gas Corporation v. Amend*, 392 S.W.2d 744 (Tex.App. 1965); *Hastings v. Pichinson*, 370 S.W.2d 1 (Tex.App. 1963); *Steeple Oil and Gas Corp. v. Amend*, 337 S.W.2d 809 (Tex.App. 1960); *Reid v. Gulf Oil Corporation*, 323 S.W.2d 107 (Tex.App. 1959).

next ensuing after the expiration of ninety (90) days from the date such well is shut-in and thereafter on the anniversary date of this lease during the period such well is shut-in, to the royalty owners or to the royalty owners' credit in the rental depository bank hereinafter designated. *When such payment or tender is made it will be considered that gas is being produced within the meaning of the entire lease.*⁶⁴

with this:

If a well capable of producing gas or gas and gas condensate in paying quantities located on the leased premises (or on acreage pooled or consolidated with all or a portion of the leased premises into a unit for the drilling or operation of such well) is at any time shut-in and no gas or gas condensate therefrom is sold or used off the premises or for the manufacture of gasoline or other products, *nevertheless such shut-in well shall be deemed to be a well on the leased premises producing gas in paying quantities and this lease will continue in force during all of the time or times while such well is so shut-in*, whether before or after the expiration of the primary term hereof. Lessee shall use reasonable diligence to market gas or gas condensate capable of being produced from such shut-in well but shall be under no obligation to market such products under terms, conditions or circumstances which, in Lessee's judgment, exercised in good faith, are unsatisfactory. *Lessee shall be obligated to pay or tender to Lessor within 45 days after the expiration of each period one year in length (annual period) during which such well is so shut-in, as royalty, an amount equal to the annual delay rental herein provided applicable to the interest of Lessor in acreage embraced in this lease as of the end of such annual period and included within the confines of a pooled unit declared under the terms hereof or created by order, rule or regulation of any governmental authority; provided that, if gas or gas condensate from such well is sold or used as aforesaid before the end of any such annual period, or if, at the end of such annual period, this lease is being maintained in force and effect otherwise than by reason of such shut-in well, Lessee shall not be obligated to pay or tender, for that particular annual period, such sum of money. Such payment shall be deemed a royalty under all provisions of this lease.*⁶⁵

A careful examination of these clauses reveals that two distinctly different events are the conditions that hold the lease. In the first, the payment of shut-in royalty itself perpetuates the lease. In contrast, in the second clause, just completing the well is the lease perpetuating condition. Payment of shut-in royalty is still required, but it is specifically denominated "a royalty". Under this sort of shut-in clause, failure to timely pay shut-in royalty should not be

⁶⁴Producers 88 (Oklahoma) lease form. "Shut-in clause" (emphasis supplied).

⁶⁵A.A.P.L. Form 680 oil and gas lease. "Shut-in Clause" (emphasis supplied).

fatal, even in jurisdictions like Texas.⁶⁶

Now, the \$64 question. A Lessee completes an Arkansas gas well capable of producing in paying quantities. The well is several miles from the nearest pipeline. The Lessee concludes that the best course of action is to shut-in the well until further development in offsetting drilling units will justify the cost of transporting the gas from the well. Then, by inadvertance, the Lessee fails to pay shut-in royalty when it becomes due. Has the lease terminated?

Of course, no one knows the answer to that hypothetical question. In the first place, we don't know whether Arkansas is among those jurisdictions that require marketing as an essential part of producing. And, our hypothetical question has something important missing. Exactly what does the shut-in clause say? If the shut-in clause makes payment of shut-in royalty a condition, then the Court should hold that the lease has terminated unless it follows decisions like those from Oklahoma to the effect that mere discovery is equivalent to production. On the other hand, if the shut-in clause states that shutting in a well capable of paying quantities is equivalent to producing it, the lease should not terminate regardless of whether the Arkansas Court adopts the Oklahoma rule or the Texas rule. Under such a clause, the Lessee is duty bound to pay shut-in royalty, but if he fails to do so inadvertently, he doesn't lose the lease, he just owes a debt.

LESSEE'S IMPLIED COVENANTS

If the Lessee discovers paying quantities and either markets or shuts-in the product, the lease will survive into the secondary term. Even then, though, because of the nature of the relationship between the parties, the Lessee owes certain continuing duties to the Lessor. These duties are often called "implied covenants". Failure to perform one or more of them

⁶⁶Incredibly, every one of the Texas cases in Footnote 61 (infra) has involved a clause which made payment of shut-in royalty the critical condition. Lessees in Texas might want to try the other type of clause to see if it makes any difference.

may subject the Lessee to cancellation of part or all of the lease⁶⁷. Nonperformance of an implied covenant may also subject the Lessee to liability for damages in a proper case.⁶⁸ Implied covenants which impact upon the secondary term include the Lessee's duty to drill additional development wells⁶⁹, duty of diligent and proper operation⁷⁰, duty to market the product⁷¹, duty to protect against drainage⁷² and duty of further exploration⁷³. The Arkansas Supreme Court has, in dicta, recognized each of these covenants.⁷⁴ There is a vast number of decisions of courts from oil and gas producing states construing one or more of these duties. These decisions reveal many nuances in the law which vary from state to state. In this brief discussion, we shall deal only in generalities.

The duty to drill additional development wells begins after the Lessee makes the initial discovery of paying quantities. He is then required to continue to drill wells to develop that discovery, if a prudent operator would do so. This covenant is probably more important in jurisdictions where increased density drilling is permitted. In Arkansas, unless the producing formation is part of a common source of supply which was discovered prior to the effective date of the Conservation Act⁷⁵, the Arkansas Oil and Gas Commission will not grant a production allowable for a second or subsequent well within the same drilling unit if it cannot

⁶⁷Which may be immediate or may be conditional upon the Lessee's failure to come into compliance by some court imposed deadline.

⁶⁸See Kuntz, *The Law of Oil and Gas* Chapters 54-62 [Replacement 1978].

⁶⁹See Kuntz, *The Law of Oil and Gas* Chapter 58.

⁷⁰See Kuntz, *The Law of Oil and Gas* Chapter 59.

⁷¹See Kuntz, *The Law of Oil and Gas* Chapter 60.

⁷²See Kuntz, *The Law of Oil and Gas* Chapter 61.

⁷³See Kuntz, *The Law of Oil and Gas* Chapter 62.

⁷⁴*Amoco Production Co. v. Ware*, 269 Ark. 313, 602 S.W.2d 620 (1980).

⁷⁵February 20, 1939. As amended, this act is codified as A.C.A. §15-71-101 through §15-72-904.

be proven that the two wells are not draining the same common source. Since a prudent operator is not required to drill a well he can't legally produce, most further development within the drilling unit would be imprudent.

The duty of diligent and prudent operation is a catch-all. An example of a claimed breach of this covenant is in *Amoco Production Co. v. Ware*⁷⁶. There the plaintiff sought cancellation claiming that the Lessee had failed to act as a prudent operator when it withdrew its appeal of an Oil and Gas Commission order establishing 160 acre drilling units instead of 80 acre units. In that case, the Arkansas Supreme Court gave deference to the Lessee's good faith judgment and held that no covenant had been breached.

The Lessee's duty to market the product is often related to his duty to produce in paying quantities and comply with the shut-in clause. As discussed above, the Lessee can only perpetuate the lease into the secondary term by finding paying quantities. He can only shut-in a well which is capable of production in paying quantities. The Lessee then still has an implied duty to try to market the product on favorable terms. If he is not immediately successful, he must comply with the shut-in clause. Failure to do so will cause loss of the lease or, at minimum, liability for damages. If the Lessee is still unsuccessful in marketing the product after a substantial period of time, he becomes susceptible to a two pronged attack. Perhaps he has breached the implied covenant to market by not being as aggressive a salesman as prudent operations would have dictated. If he has been prudent in his marketing efforts then why has he failed? Perhaps he didn't have paying quantities in the first place.

One recent Arkansas case on the implied covenant to market involves other issues. In *Taylor v. Arkansas Louisiana Gas Company*⁷⁷, the plaintiff sought judgment for additional royalties because the price being paid to the Lessee was substantially below the current market. The gas was contracted for under a long term agreement. The price provided for was a favorable price when the agreement was entered into. The United States District Court,

⁷⁶269 Ark. 313, 602 S.W.2d 620 (1980).

⁷⁷604 F.Supp. 779 (W.D.Ark. 1985), affirmed 793 F.2d. 189.

applying Arkansas law, held for the Lessee:

The plaintiff has failed to prove that the gas contracts were not reasonable or were not executed in good faith or at arm's length. The court finds that the prices recited in the Arkla-Stephens contracts were at least equal to the prevailing market prices at the well at the time of the contracts' execution. Accordingly, the lessor, Taylor, is not entitled to any additional royalties from Stephens or Arkla under the market price leases.⁷⁸

The physical characteristics of oil and gas make them susceptible to drainage from wells nearby. Thus the Lessee has a continuing implied duty to protect the correlative rights of his Lessor by drilling to prevent drainage. In most situations the product remains in the ground notwithstanding the Lessee's failure to prudently perform. That is not so when the oil or gas has been lost irretrievably to wells on other lands. Thus, violation of this covenant is likely to expose the Lessee not only to cancellation but damages as well.

The duty of further exploration differs from the duty to drill additional development wells. It implies a duty to explore for production not found in existing wells. For example, if the lease covers more than one tract, the Lessee has a duty to prudently explore all tracts. Moreover, if a lease is being held only by shallow production and the lands are clearly prospective at deeper horizons, the Lessee has been held to a duty to explore deeper.⁷⁹

The most common remedy for a Lessee's breach of implied covenant has been cancellation of the lease. Cancellation is an equitable remedy. It is the equivalent of a forfeiture and equity abhors a forfeiture. Thus, ordinarily, if a court grants cancellation it will permit the Lessee to keep his producing well(s).⁸⁰ Cancellation is frequently made conditional. In such cases, the Lessee will be given a deadline to comply. Only if he then fails to meet the deadline will cancellation occur.⁸¹

⁷⁸*Taylor v. Arkansas Louisiana Gas Company*, 604 F.Supp 779 at 784 (W.D.Ark. 1985).

⁷⁹*Stevenson v. Barnes*, 288 Ark. 147, 702 S.W.2d 787 (1986).

⁸⁰*See, e.g., Stevenson v. Barnes*, 288 Ark. 147, 702 S.W.2d 787 (1986); *Nolan v. Thomas*, 228 Ark. 572, 309 S.W.2d 727 (1958).

⁸¹*See, e.g., Arkansas Oil and Gas, Inc. v. Diamond Shamrock Corp.*, 281 Ark. 207, 662 S.W.2d 824 (1984).

Also, due to the equitable nature of the remedy, the Lessor usually is required to demand compliance before the cancellation will occur.⁸² However, in *Byrd v. Bradham*⁸³, the Arkansas Court held that a demand was not required when there had been inactivity for an unreasonable length of time (28 years). There has been some concern that this case opens the door to surprise cancellations in Arkansas. More likely, its holding is limited to its facts and the Arkansas Court would still require notice under most circumstances.

THE PUGH CLAUSE AS A LIMIT ON THE SECONDARY TERM

Some oil and gas leases contain a clause which limits the secondary term to lands within drilling units where production is discovered during the primary term. Such a clause is known as a "Pugh Clause", named after Lawrence G. Pugh, who is given credit for its invention. A typical Pugh Clause might provide:

Notwithstanding any provision herein to the contrary, this lease shall expire at the end of its primary term as to all lands hereinabove described which are not then contained within an established drilling unit containing one or more oil or gas wells capable of producing in paying quantities. This lease shall also then expire with respect to lands within such drilling units as to all those depths below the stratigraphic equivalent of the base of the deepest producing formation therein.

A Pugh Clause is an express provision which limits the habendum clause. While it will be given effect, it needs to be written precisely. In the case of *Bibler Brothers Timber Corp. v. Tojac Minerals, Inc.*⁸⁴, the Arkansas Court construed a clause which read as follows:

In the event, however, that only a part of the lands embraced by this lease are included in a unit created hereunder, that the remaining portion of the lands embraced by this lease shall be subject to delay rental payments as provided in Paragraph 4.

The Arkansas Supreme Court held that this language did not constitute a Pugh Clause. Instead, it merely subjected outside acreage to delay rental payments and, since delay rental

⁸²Kuntz, *The Law of Oil and Gas* §§ 58.4, 59.4, 60.4, 61.4 and 62.4 [1978 Replacement].

⁸³280 Ark. 11, 655 S.W.2d 366 (1983).

⁸⁴281 Ark. 431, 664 S.W.2d 472 (1984).

payments were no longer due after the expiration of the primary term, it was then meaningless. Also, since the drilling unit formed in *Bibler Brothers Timber Corp. v. Tojac Minerals*⁸⁵ was formed by compulsory action of the Arkansas Oil and Gas Commission, it was not a unit "formed hereunder" within the meaning of the clause in question.

THE "STATUTORY PUGH CLAUSE"

Oklahoma and Arkansas have each adopted statutes limiting the application of habendum clause in acreage outside of producing units. In Oklahoma, the statute provides:

In case of a spacing unit of one hundred sixty (160) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease.⁸⁶

This statute was enacted as of May 25, 1977 and has been held to apply only to oil and gas leases entered into after that date.⁸⁷

Arkansas' "statutory Pugh Clause" is more complex and somewhat confusing:

(a) The term of an oil and gas lease or oil or gas lease extended by production in quantities in lands in one (1) section or pooling unit in which there is production shall not be extended in lands in sections or pooling units under the lease where there has been no production or exploration.

(b) This section shall not apply when drilling operations have commenced on any part of lands in sections or pooling units under the lease within one (1) year after the expiration of the primary term, or within one (1) year after the completion of a well on any part of lands in sections or pooling units under the lease.

(c) The provisions of this sections shall apply to all oil and gas or oil or gas leases entered into on and after July 4, 1983.⁸⁸

Apparently this statute means:

(1) If all drilling activity occurs during the primary term of the

⁸⁵*Ibid.*

⁸⁶Okla. Stat. Ann. § 52-87.1.

⁸⁷*Wickham v. Gulf Oil Corp.* 623 P.2d 613 (Okla. 1981).

⁸⁸A.C.A. § 15-73-201.

lease, then acreage outside producing units will cease to be leased one year after the expiration of the primary term;

(2) If a well is commenced within one year after the expiration of the primary term, acreage outside producing units will not expire until one year after that well's completion;

(3) Successive one year extensions can be obtained by the Lessee if he continues to commence new wells within the previous "one year from completion";

(4) As long as the Lessee commences a well somewhere on the leasehold within one year from the previous completion he need never drill on all the lands covered by the lease.

It's also possible to read the statute differently and reach a more absurd conclusion. Read literally, Section (b) seems to say that if a well is commenced within one year after expiration of the primary term or, at any other time within one year after completion of another well on the lease, then the statute just doesn't apply. Certainly, that is not with the legislature meant, but it might be worth arguing.

Another problem with the Arkansas statute is that it does not define "completion". In all probability the Supreme Court will someday supply that definition. A likely candidate is the date upon which the completion report is filed. However, if that date is adopted, the drilling of a dry hole would not entitle the Lessee to another year, since no completion report results from a dry hole.

CONCLUSION

The news is bad and good. The secondary term can last forever, in theory. Unfortunately, there are many potholes in the road to eternity.